

DOW THEORY LETTERS INC.

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Letter 646

Oct. 17, DJIA 832.18; PTI 329; A-D ratio -29.77

Oct. 24, DJIA 840.52; PTI 347; A-D ratio -29.27

DISCOUNTING and HYPOCRISY: The man and his wife leave church after the regular Sunday sermon. The sermon was entitled, "Living the True and Right Way." Half a block from the church the man and his wife run into another couple, a couple they are friendly with. The second couple is dragging a grim-faced child with them. The two couples stop to talk. The child tugs on the father's arm, whereupon the father suddenly turns and slaps the child hard across the face. There is a moment of shocked embarrassment. The church couple is incensed but says nothing. They continue talking as if the sadistic incident had never happened. Their church-going has been a ritual and a farce; they don't really believe in the power of truth, they don't really believe in the power of God within themselves. What they really believe in is a single thesis, "Play it safe, and don't make waves."

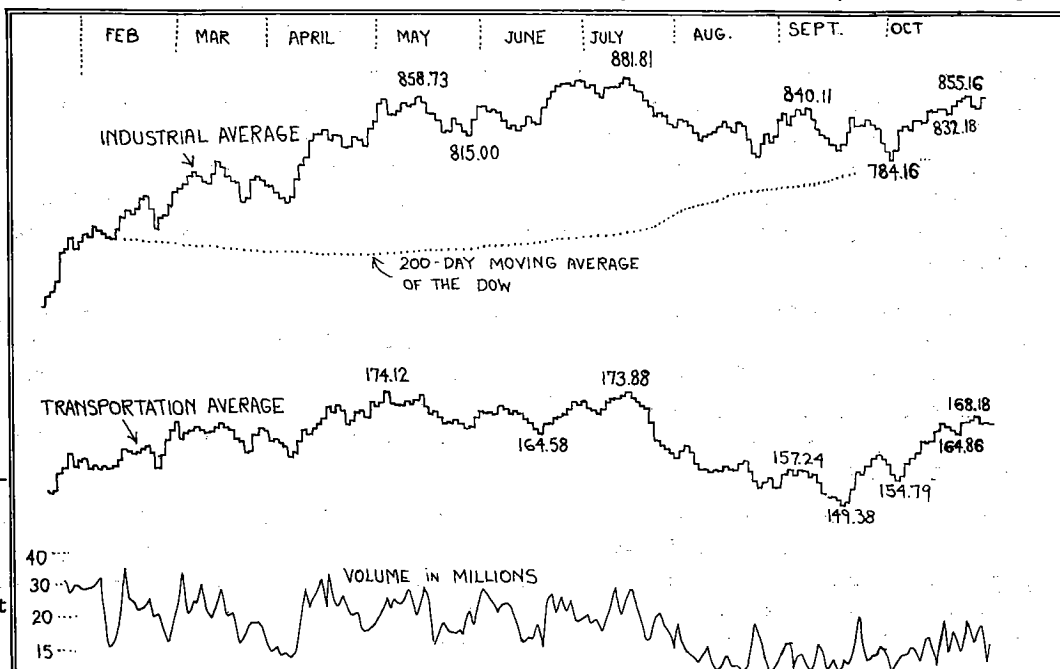
Two investors meet. They discuss the market. "How do you feel about the market, Dave?" asks Duane. "I'm bullish as all get out, Duane. I just put about two-thirds of my assets in common stock. I mean I'm loaded with shares of America! How about you?" Duane grins, "I'm optimistic as can be, Dave. I think the Dow is going to 1200 by mid-1976." Dave whistles, "Gad, man, that's quite a statement. Been loading up on stock, have you?" "Well, not yet, I haven't," says Duane, "but I'm getting ready to move in there big." Dave shakes his head. "You're not really bullish, Duane. You're a bear that's talking bullish. A man who's really bullish buys stocks. That's acting like a bull. A man who talks bullish is just a talker. He'll never lose any money, but he'll never make any either. He's kidding himself, that's all."

The Dow Industrials plunge to 577.60 in December, 1974. The advance-decline ratio and most stocks have crashed to outlandish lows. Most of the comprehensive unweighted stock averages have lost anywhere from 75% to over 85% of their peak values. Individual stocks have been crucified, cut to ribbons. It's been the worst Wall Street fiasco since the depression days of the 1930's. The market as a whole has discounted everything short of the collapse of Western civilization. No one can understand why the stock market has come down so big and so hard. Fortunes have been wiped out. The assets of many major institutions have been reduced from 33% to 50% of their peak values.

As 1975 comes in it is obvious that a severe recession is on. Business slumps, profits slide, many companies show losses. Unemployment climbs over the 8% level, auto and housing sales slump, and most astounding of all, the market climbs steadily higher. Observers of the Wall Street scene are flabbergasted. In May the market falters, then pushes higher into July. From July to October a major correction hits the stock market. In October New York City slides to the edge of bankruptcy, and the mood of the nation turns black.

"Nobody" can understand why the market is holding. Nobody can figure out why the Dow shows a mere 5 point loss on October 17 when NYC is within a hair of defaulting on half a billion dollars worth of debt. Nobody can understand why the market surges higher during late-October when everybody knows that the country is beset with a thousand economic problems.

But what people really do not understand is that the market discounts, and once having discounted, moves on. "What the hell are you talking about, Russell," shouts Duane. "I understand the discounting process! But who was thinking in terms of a New York default on half a billion! That's not a problem, that's a national disaster." And my answer is that when the unweighted stock averages lost 85% of their total value during 1973 and 1974, that action represented a disaster for



Page 2 Wall Street. The crash of 1973-74 discounted everything we're seeing today and more. Wall Street always prepares itself in advance for what is coming up (excluding Acts of God). "When coming events cast their shadows before," wrote the great William P. Hamilton, "those shadows fall on the New York Stock Exchange."

Today's shadows have all been cast. They have been seen by the Averages. They have been fully discounted. The market at the '74 lows measured the worst of the coming year 1975. The Averages at the 1975 lows of September and October discounted the worst that could be seen ahead for the rest of 1975. Industrials and Transports have already bettered the peaks of August and September. The recovery highs of 174.12 (Transports) and 881.81 (Industrials) loom ahead. Bettering those peaks represents the next technical problem for the market. Since we are in a primary bull market it should be only a matter of time before the 1975 recovery peaks are hurdled.

If the '75 highs are passed, the market will be saying that the air is clear for as far ahead as the best financial eyes in the nation can see. That distance is pretty far. Historically it is six months to a year ahead. So let's relax. Let's let the market do the talking. Let's let the Averages deliver their message. Most of my subscribers "say" they believe that the Averages possess the power to discount the future. Yet, I would guess that perhaps 10% of my subscribers act fully on the verdict of the Averages, probably 50% of my readers act to some extent on what the market is saying, maybe 30% do nothing either way (which is OK with me), and 10% fight the market (i.e., they short a primary bull market or buy a primary bear market, which is not OK with me).

I do my best to put everyone's mind and money on the correct side of the primary trend. I can't tell you exactly how much to buy, what exact percentage to buy, or on what exact day to buy or sell. It used to be said that "The market is your enemy, and it's out to break you." I never could quite swallow that, although I've often felt that way. What I really believe is that "The market is neutral, and we're our own worst enemy." So my advice is — either really believe that the market discounts, believe that the Averages can look ahead — or get out of Wall Street. Because the market has its own way of handling the dis-believers. It breaks them — it breaks them financially as sure as I am writing this. And that you better believe, because I've seen it happen time and time again.

THE MARKET: One rule that I have repeated for subscribers is this: Following a high-volume advance, watch what stocks do when volume declines. If stocks fall away as volume contracts, if the A-D ratio goes down big on declining volume, it's a negative situation. Such action means that the high-volume buyers have been locked in during the low-volume fall. BUT, if, following the high-volume advance, stocks tend to hold their gains when volume contracts, then you have a very strong market. It means that the bull is just resting, and when he's caught his breath he's going to start pawing and snorting again. It also means that the high-volume advance brought in a minimum of profit-taking (in other words, nobody wanted "out").

Following the rising-volume advance to the mid-October peaks (see chart on page 1), the market became unsettled again by the NYC situation. On October 23 (last Friday) the Industrials dropped over 14 points, but the A-D figures did not indicate any particular weakness in the general market. On Monday (Oct. 27) the market backed and filled, but again no particular weakness evidenced itself in the advance-decline figures. All during October the public (odd lots) has been continuing to sell heavily with odd lot ratios persistently holding at ratios of two to one more (in sales over purchases).

There is little question but that the market is at least preparing itself for a NYC default. The Averages have been backing off in order to cushion themselves against the possible public shock of a bankrupt Fun City. My guess is that the discounting process is about over, and that if and when NYC actually does default, a rally will be set off. The bad news will be out, and the market will be ready to head higher again (propelled by the enormous upward force of the primary bull trend).

I want to say here that I expect the current period of pessimism on the part of the public to gradually but persistently give way to a period of equally intense optimism. Why do I say this? Because I know that we are in a primary bull market and just as news tends to go with the trend in a bear market, it also goes with the trend in a bull market. Just as nothing seems to "work out" during a bear market, everything seems ultimately to work out during a bull market. Therefore, by first or second quarter 1976 I would expect to see today's odd lot public turn less pessimistic, then mildly bullish and finally very bullish as this bull market pushes the Averages and most stocks higher (despite all the various adversities and potential catastrophies that currently loom on the horizon).

CAPSULES: The Dow closed at 832.18 on October 17, Transports at 164.86. That was the day (Friday) on which NYC was a hair's breadth away from defaulting. The market climbed strongly from the October 17 lows. On October 20 Industrials confirmed the previous indications of Transports by climbing bullishly above the 840.11 level. The October 17 closes represent the market's discounting of an actual default by NYC. Wall Street seldom (if ever) discounts the same thing twice. As long as one or both Averages hold above the 832.18 and 164.86 level, the secondary trend will remain bullish (despite any and all news regarding NYC or anything else).

The A-D ratio has advanced on 14 of the 18 trading days or 78% of the time since October 2. When this occurs, I generally consider the market to be in an "overbought" condition. However, during very strong primary bull movements the market can stay overbought for a surprising length of time, and this is what may now be occurring. At any rate, in view of the long string of advances, it would not be surprising to see signs of strain or correction entering the picture (in very strong markets sideways action can also take the place of downward corrections in price).

One reason why this bull market stays technically strong is that it provides daily and weekly "new worries" for investors and the public. It's been the same all the way up: "Volume is too low," "The Transportation Average won't confirm," "Breadth is lagging," "The new highs are sluggish," etc. At the same time, the fundamentals have been perfect for keeping everybody sitting on their hands: "Auto and housing sales are slow," "Inventories are too high," "Commodities are booming," "Commodities are collapsing," "Interest rates are too high," "NYC is burning," on and on. Yet the Dow is now 270 points higher than it was at the December 6 low of 577.60. Anyone who doesn't believe that a primary bull market "climbs a wall of worry" should study the market action and the news of the past year!

On October 24 the 13-week momentum line (see last Letter) for the Dow Industrials turned bullish (at a reading of 102) for the first time since March, 1975. This should represent a strong plus for the market, despite the NYC crisis and despite the fact that the market may have to "work off" an overbought condition.

In the last few Letters I have been saying that we may be entering the third "buying stampede" area of 1975. I identify a buying stampede as a period of persistent upside action on the part of the great majority of stocks. In retrospect, we know a buying stampede has occurred when the A-D ratio climbs five points or more without so much as an intervening one point decline. I believe we could be seeing the rare stampede phenomenon now.

The market (during October) has been producing a large number of unchanged issues each day, issues which did not advance or decline. This is indicative of some resistance and a good deal of concentration on certain issues ("selectivity"). I feel that selectivity is a characteristic (in this particular market) of institutional and investment-type buying. If NYC is settled one way or the other, the public will probably lose its bearishness. When that occurs, the market will broaden and "everything" will get its turn on the upside.

NEGATIVE VOLUME: I have talked about the negative volume index in recent Letters. This is the index that warned of internal (technical) weakness following the March peak in breadth (i.e., the A-D ratio). Now the negative volume index (NVI) may be telling us another story, and I want to go into it.

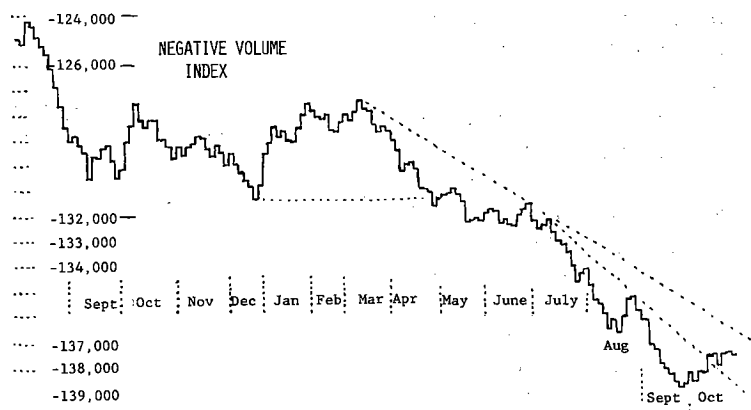
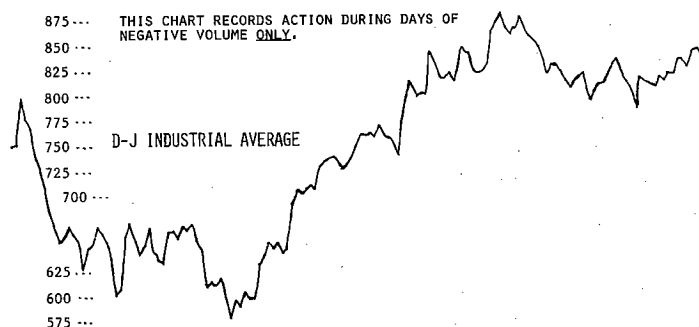
Negative volume is the advance-decline differential on days (and only on those days) when total NYSE volume contracts below the preceding day's total volume. In other words, if Monday's volume was 16 million shares and Tuesday's volume was 15 million shares, we immediately enter Tuesday's A-D differential on the NVI. If Wednesday's volume jumps to 17 million shares we ignore the NVI because Wednesday produced expanding or positive volume.

The theory of NV was first put forth by Paul Dysart of Trendway. Dysart's thesis was that big money prefers operating in "calm waters" or when volume is lower, while the public moves when the market becomes exciting or during times of expanding volume. Therefore, Dysart constructed his NVI which tends to show, over any extended period of time, the direction which big money or informed investors are taking.

The accompanying chart shows all the negative volume action for the past 12 months. Note that NVI hit an important bottom last December, corresponding with a major bottom for the Dow (the Dow hit its 577.60 low on Dec. 6). From December to March NVI headed bullishly higher, corresponding with the explosive rise in the general market. From March to May NVI headed down, and in this area the general market turned ragged. From May through late-June NVI moved sideways to higher, and this corresponded with strong upside action in the market.

On June 30 the NVI hit a peak, then headed lower. I took this as a warning of trouble ahead (see Letter 638). Two weeks later, on July 14, the Dow topped at 881.81. A secondary reaction began, and the market continued down. On September 25 the NVI struck what I believe was an important low. A week later (October 1) the Dow recorded its reaction low of 784.16.

Now note that since the September 25 low, the NVI has been trending irregularly higher. On October 7 the NVI pushed above the declining trendline (see chart) which has been in force since June. But the trendline I am watching with the most interest is the seven-month declining trendline which starts from the March peak. As the bull market struggles upward, the NVI moves nearer and nearer to a reversal of this bearish March-October trendline. I believe



the NVI is going to push above it in the near future. If and when this occurs, my feeling is that the whole character of the market will change. It will change to one of heavy buying, upside excitement and obvious primary bull action. In a phrase, when the March to October NVI trendline is bettered, "we're going to know we're in a bull market."

MOVING AVERAGES: I use three moving averages of the Dow in my technical work, and the "signals" provided by the various crossings of these MA's can be useful for both trading and investing purposes. Referring to the accompanying chart, the short-term MA is a 4-week moving average of the Dow. The dotted line is a 13-week or intermediate-term MA. The heavy black line is a 50-week or long-term MA.

Major buy or sell signals are given when the 13-week MA rises above or drops below the 50-week MA. These major buy and sell signals occur rather infrequently. As you can see on the chart, the last sell signal was given on April 19, 1973. Those of us who abided by this signal avoided the worst stock market disaster since 1937-38. The 1973 sell signal was in force for two years. A major buy signal was given on April 4, 1975, and that buy signal is still in effect.

Veteran readers know that I always have given the greatest credence to a signal that occurs in harmony with the primary trend. Thus, I took the 1973 sell signal very seriously, since under my analysis the market was in a primary bear trend during 1973. I took the 1975 buy signal just as seriously, since it had come following a confirmed primary bull market signal (which occurred in January, 1975).

"All right," you say, "but these major signals seem to come late. How can we use this study to move faster, to get in and out earlier?" And the answer is that we can use the buy and sell alerts, which are given when the 4-week MA crosses above or below the 13-week MA. "Yeah," you retort, "but don't the buy and sell alerts produce a lot of whipsaws?" And here the answer is that we can and do get whipsaws on the alert signals. But again, these signals (i.e., the alerts) are considered most valid when they occur in harmony with the prevailing primary trend. Also, long-term investors may, if they wish, ignore all alert signals that occur against the prevailing primary trend.

In Letter 639 I drew attention to a sell alert which occurred on August 7, 1975. That sell alert was followed by market weakness which carried into late-September and October (the Dow hit its low on October 1). I find it significant that following the August 7 sell alert, the 4-week MA dropped sharply lower (see chart) for three successive weeks, then formed a "saucer bottom" pattern (which is a bullish structure). During the same period the 13-week MA slid very grudgingly lower.

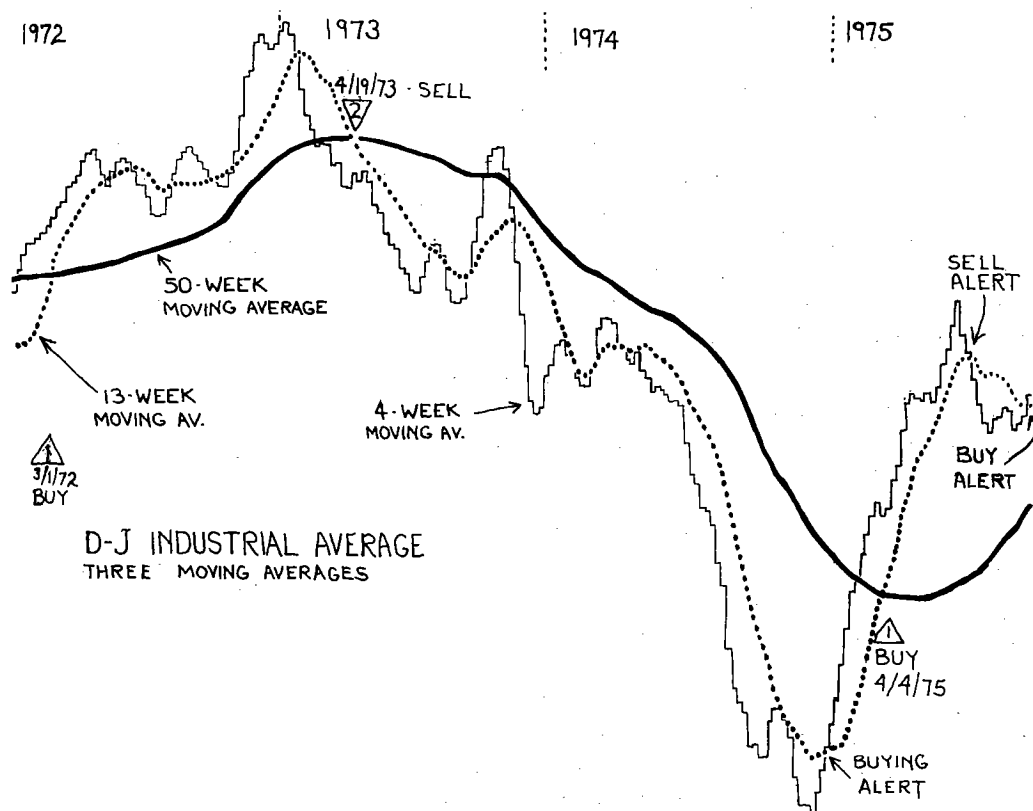
At the present time, despite the fact that the 13-week MA topped out 12 weeks ago, the 13-week MA is still 57 points above the 50-week MA. Thus the 13-week MA has remained persistently and comfortably far above the 50-week MA. The MA's never got near a major sell signal.

But of particular interest is the current status of the 4-week and 13-week MA's. The 13-week MA has been losing downside momentum, and it currently stands

at 821. The 4-week MA, having formed its saucer bottom, has turned up. On October 24 the 4-week MA jumped to 826 4 points above the latest 822 reading on the 13-week MA. This means that a buy alert has been rendered.

Since both of the short-term MA's are still well above the 50-week MA, and the 50-week MA is climbing, I interpret the whole MA's study to be bullish on a minor, secondary and primary basis. The mid-1975 market correction should now be considered completed.

GOLD: During a bear market any low followed by a rally can conceivably mark the termination of that bear market. Thus, the September 23 low of 128.75 for gold bullion could have represented the bear market low for the metal. Technically, the evidence is not in yet, and that evidence (if Sept. 23



will take time. Personally, I'm impartial, I'm in no great hurry to find out, but I am intensely interested.

Glancing at the gold momentum chart, you will note that following a shallow rising cycle and then a shallow declining cycle, gold is probably close to turning up again (on a momentum basis). Whether the new advancing momentum trend will be weak or powerful cannot be known at this time. There are a few guideposts, however.

The gold decline from the 1974 record peak of 195.25 to the 1975 low of 128.75 was 66.50 points. The halfway level to the upside would be 162. Thus, 162 would be the first major target on the upside, if gold is to turn bullish. Confirming this line of reasoning is the point & figure chart (3-box reversal). The chart shows that the first upside target for bullion is the steeper intermediate trendline which would be met at a price of around 160. The much more important (and shallower) trendline would be reversed to the upside if gold rallied to around 170. But considering that lateral motion is almost certain to occur if gold continues to rise, I would guess that gold would probably reverse the major trendline (along with some sideways motion) at a price of about 165. All of this, of course, could only occur through time; it could not occur overnight.

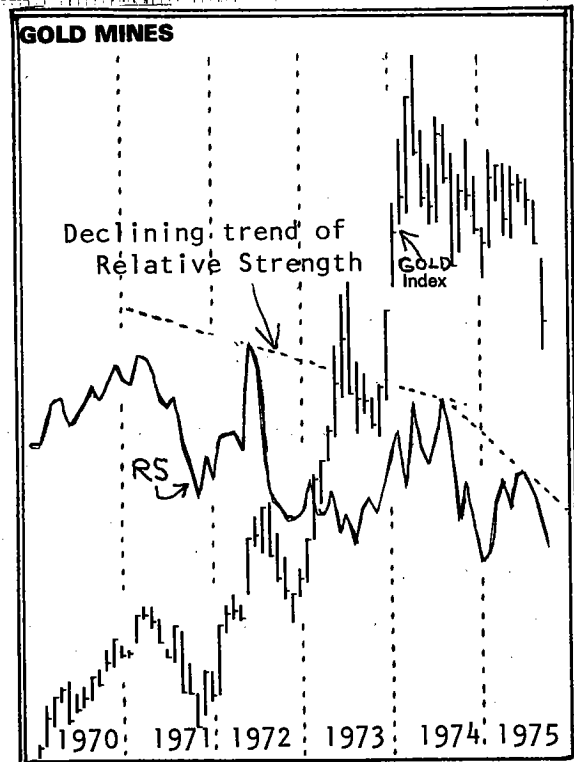
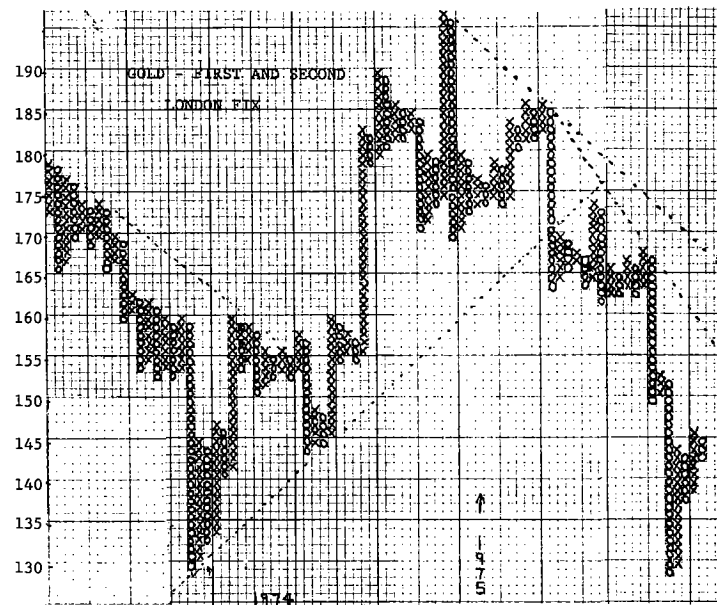
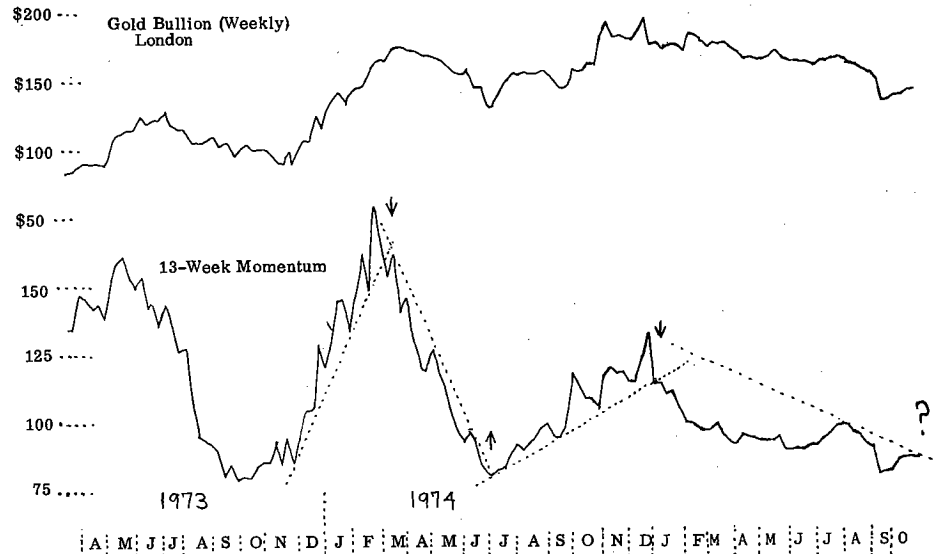
The next thought is less pleasant. The next gold chart shows the monthly value of the shares and the relative strength of the shares compared with bullion since 1970 (chart courtesy of Capital Inter. Perspective). What the chart shows is that from 1970 to 1972 the shares and bullion acted about in unison, but since 1972 the shares have steadily lost strength compared with the price of gold.

This action is in line with the warnings I have issued regarding the problems of the mines, problems which include higher taxes (particularly in Canada) and very much higher costs and wages (with special reference to S. Africa). On top of that, we have political uncertainties and the chances of property confiscation or erosion of property values. So it is easy to see why gold in the hand is increasingly worth more than gold in the ground (the latter being represented by gold shares).

I now come to the very unpleasant concept of a higher price of gold's not being all that bullish for the stocks. After all, if the December 30, 1974 record peak of 195.25 couldn't take the gold shares above their previous bull market highs, how is 160 or 180 dollar gold going to do it today (assuming we even get considerably higher gold in 1976)?

The fact that no one in the gold business wants to hear is that gold and gold shares are in a primary bear market, and they will remain in a bear market until the contrary is proved. So far, I see the seeds for a possible change, but nothing, and I repeat nothing, definite has occurred as yet.

As for the gold shares, it is conceivable that stocks may be in the process of forming major bottoms. However, the patterns and volume indications suggest to me that even if September, 1974 represented the ultimate bottom and September, 1975 represented the 1975 low, there will be plenty of time ahead for purchase of gold shares (if we decide that buying is



Page 6 right). In the meantime, I continue luke-warm to negative on the gold shares.

The question has come up as to whether I would prefer a token 10% to 15% in assorted gold shares or a "no gold share" position for subscribers. My answer is that I have no particular preference at this time. Believers in gold, however, can buy a lot more gold shares for their bucks now than they could have a few months ago, but in general I personally would rather buy on real evidence that the gold bear market is over. I don't have that evidence yet.

LATE NOTES: As this is written President Ford has finished his NYC speech. NYC is to default and Mr. Ford will veto any Federal bailout bill. After rallying 13 points on Tuesday (Oct. 27), the market is now down around 7 points (Oct. 28). The market continues to act as if it has all been discounted, and it is listening to a repeat performance.

There may be no other way to play it. There may be no other way to stop wild deficit spending, other than to allow the piper to be paid. The NYC debt will have to be restructured. The debt-holders are probably going to have to wait. But the banks and the investors who put up the money are going to be a mighty tough (and chastened) bunch from here on in. Reading a city's or the state's financial statement is going to be a new art. Handing out raises and pension plans is going to be a lot harder as well. Why, because the boys with the bread are going to be running scared from here on. And that means fiscal conservatism — whether it's wanted or not.

We are probably now going into a period of saner American finance. The nation's business is going to "wind down" a bit. Liquidity is going to build up. The inflation balloon has simply sprung too many leaks, and investors are becoming edgy and frightened. Maybe it's NYC that pulled the first plug. Illinois has made "bankruptcy" noises and Massachusetts sounds a bit creaky. Long term, I feel that today's seeming fiasco will prove to be bullish. Long term, I believe the national will stand, assuming the inflationary air is released from the balloon. The fact is that deficit financing and inflation would ultimately topple the US. No nation in recorded history has ever withstood continuous deficits and inflation. But many nations have withstood stagnant conditions and deflation. Meanwhile, NYC, the nation's counterpart of a drunken sailor, is facing the music. And we may all have to do a bit of dancing to that tune. But the outcome, according to Wall Street, is to be in favor of the bull.

STOCKS: Anyone who has owned mutual funds has probably found them easy to buy but hard to sell. As trading mechanisms, the funds have always had the drawback of being a very large pain in the fanny to sell. Yet, the no-load fund can be an excellent trading mechanism, as are some of the variable annuity funds (wherein you can switch from high-yielding income funds to stock funds and back). Ask your broker about the variable annuities.

I am indebted to Yale Hirsch for the following excellent description of the mutual fund trading situation. It sounds good to me (from Mutual Funds Scoreboard, 6 Dee Trail, Old Tappan NJ 0765).

* * *

Add to last week's recommendation of leisure stocks outstanding performers such as Howard Johnson and Hilton Hotels. Host International has also been acting well, and this big food dispenser (gift shops, airport restaurants) was first recommended last December at 5. Another group which is showing superior relative strength is the rubber group, with Firestone and Good-year and Uniroyal (more speculative) showing charts indicative of accumulation.

The food stocks are also acting well with General Foods (recommended months ago) now showing aggressive institutional buying and Consolidated Foods all over the Board in heavy accumulation. Beatrice Foods and Fairmont are two stocks that have not yet "gotten away" on the upside, and I like them both. Lower commodity prices and a cessation of inflation should help the food processors.

In the meantime, those of us who purchased the closed-end bond funds such as Excelsior, Pacific-American or Transamerica Income, have paper profits of up to 20% plus 10% in income, which ain't half bad in any market.

THOUGHT FOR INVESTMENT ADVISORS: India's famous leader, Mahatma Ghandi, was asked, "Sir, how could you say one thing last week and this week say something totally the opposite?" "Ah," said Ghandi, "you see I have learned a great deal in the latest week."

APOLOGY: Through total coincidence, I used the name Charles Johnson in a fantasy dialogue on page 5, Letter 643. It was most definitely not my intention to make reference to Mr. Charles B. Johnson of Franklin Resources, Inc., San Mateo, CA.

Next mailing: November 12.

As most of you know only too well, it is easy to buy, but relatively difficult to sell mutual fund shares. In most cases, letters of redemption with the signature guaranteed must be sent out. If the fund is located in another part of the country, more than a few days can elapse before the request for redemption is received, several more days will go by before the monies are received. Stockholders have never had to contend with these lags. A call to a broker suffices! Now, the same service is available to mutual fund shareholders. Three fund groups have moved to facilitate buying and selling mutual funds by telephone.

Boston's Fidelity group has the most comprehensive telephone/switch capability. Four of their funds have gone no-load and investors can achieve maximum investing flexibility by switching between them at no charge, simply by placing a free phone call (800 225-6190, in Mass. call collect 617 726-0650). The four funds are: 1) Fidelity Daily Income Trust—one of the largest money market funds. 2) Fidelity Thrift Trust, a new fund that invests exclusively in intermediate-term, fixed-income obligations—high grade corporate, government and money market notes and bonds. The average maturity of its portfolio will not exceed seven years. 3) The Everest Fund has been renamed Fidelity Equity Income. It now invests in income producing stocks and convertible debentures. It's up almost 35% this year. 4) Contrafund is a growth fund that seeks out securities which appear to be undervalued or out of favor. It too is up 35% this year.

The essential strategy is to switch into the money market fund—or the Thrift Trust for slightly better yields—if you're bearish. Switch into one or both of the stock funds if you're bullish. Minimum initial and subsequent investments vary from fund to fund, but the minimum to switch is \$1,000. Prices received are as of the end of the day. Now the fund investor can do even better than the stockholder. He can move in and out, without fuss or bother, with no commissions to pay!